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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 547

314-660

BENJAMIN MAHLER and JULIA F. MAHLER,
Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

HARRY FRIEDMAN,
Counsel for Petitioners.

THE COURT PRESS, N. Y. C.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petition.

Petitioners, Benjamin Mahler and Julia F. Mahler, pray that a writ of certiorari issue to review that part of the judgment of the United States Circuit Court of Appeals for the Second Circuit, entered in the above cause on May 26, 1941, which affirmed the decision of the United States Board of Tax Appeals. The part of the decision sought to be reviewed relates to the worthlessness of the common stock of the Middle West Utilities Co. The Circuit Court of Appeals reversed the Board with respect to the year in which the preferred stock of the Middle West Utilities Company became worthless, and in connection therewith, petitioners seek no review.

Opinion Below.

The decision of the Circuit Court of Appeals is reported in 119 Fed. (2d) 869. The decision of the Board of Tax Appeals so affirmed and reversed by the Circuit Court, is in the form of a memorandum opinion and is not officially reported. It is set forth in full in the transcript of record filed with the Circuit Court at pages 35 to 58 inclusive.

Questions Presented.

1. Whether the decisions below were not in violation of due process of law, in that both the Board of Tax Appeals and the Circuit Court of Appeals for the Second Circuit decided the case upon an issue not raised and not tried, and without affording petitioners an opportunity to present evidence thereon.

2. Whether the Board and the Court below did not err in deciding that the common stock of the Middle West Utilities Company was worthless in 1932 when that issue was neither raised by the Commissioner of Internal Revenue, not litigated before the Board, and where the deficiency notice conceded that the common stock had value at least to December 31, 1935.

3. Whether in light of (a) the Commissioner's holding in the deficiency notice that the stock of the Middle West Utilities Co. had value up to the end of 1935; (b) the fact that in other reported proceedings the Commissioner was contesting other taxpayers' claims of 1932 worthlessness, and (c) the failure of the Commissioner at any time during the hearing to modify his position that the stock had not become worthless

by December 31, 1935, petitioners were not misled in assuming that no facts or evidence as to existence of value prior to 1934 need be introduced so that a decision based solely on evidence introduced by petitioners in an attempt to establish the occurrence of worthlessness in 1934 resulted in petitioners being deprived of a fair trial.

4. Whether there was any substantial legal evidence to support the Board's finding that Middle West common stock became worthless in 1932.

5. Whether the Board, having found, as contended for by petitioners, that Middle West stock was worthless in 1934, contrary to the Commissioner's determination that no such worthlessness had occurred prior to 1936, judgment should not be entered for petitioners allowing the loss deduction as claimed in 1934.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on May 26, 1941. The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Statutes Involved.

The statutes involved will be found in Appendix A, *infra*, page 27.

Statement.

The facts deemed material to this application are as follows:

Petitioners were the owners of both common and preferred stock of Middle West. They deducted the cost of the stock in their 1934 tax return as a loss due to worthlessness. Upon examination of petitioners' return, the Government investigator indicated that his instructions were that the stock was not yet worthless. Thereupon petitioner, Benjamin Mahler, communicated with respondent requesting a conference to fix, if possible, the year when respondent deemed the stock to have become worthless. Under date of January 19, 1937, respondent replied (R., fols. 374-5) that so far as the years prior to 1936 are concerned, "the Bureau holds that the stock * * * did not become worthless during or prior to the year 1935", and that so far as the year 1936 is concerned, it is "unable to advise * * * at this time just what position will be taken by the Bureau * * *" (R., fol. 378).

Thereafter and on February 16, 1937, respondent issued his deficiency notice confirming the holding set forth in letter of January 19, 1937 that the Middle West stock "did not become worthless during or prior to the year 1935". From this determination, petitioners on March 17, 1937 appealed to the Board, alleging that the stock became worthless in 1934 and that the Commissioner erred in not so holding. Respondent denied these allegations. The proceeding went to trial before a member of the Board on November 15, 1938.

Shortly after the filing of the Board petition in this proceeding and on April 20, 1937, the Board

promulgated its opinion in *George H. Horning*, 35 B. T. A. 897, wherein it sustained the Commissioner in holding that Middle West stock did not become worthless in 1932. Thereafter, and on November 4, 1938, eleven days prior to the date of the hearing in this proceeding, the Board promulgated its opinion in *Mary S. Peabody*, 38 B. T. A. 1086, reversing the Commissioner in his determination that Middle West stock was not worthless in 1932. At the time of petitioners' trial the Commissioner had not announced his acquiescence in this decision and neither at the hearing nor at any time thereafter did the Commissioner move either to modify the deficiency determination that the Middle West stock possessed value throughout the years 1932 to 1935, or to otherwise amend his pleading to allege worthlessness prior to 1934. Petitioners went to trial on the assumption that on the question of worthlessness, the only burden resting on them was to establish absence of value in 1934, and at no time during the proceeding did they receive any indication or intimation from the Board that the existence of value prior to 1934 (already determined in the deficiency notice) must also be established. Petitioners accordingly offered evidence, limited, as far as possible, to the issue of worthlessness in 1934.

Thereafter, the Board rendered its opinion holding that the stock was actually worthless in 1934, but that nevertheless petitioners were not entitled to the loss deduction because, in its opinion, the stock became worthless in 1932. It denied a re-consideration requested, among other things, on the ground that petitioners had not been apprised that worthlessness in 1932 or any year prior to 1934 was in issue, and that petitioners had not therefore had an opportunity to

offer evidence on that issue. The Board thereupon redetermined the deficiency.

Petitioners appealed from such redetermination to the United States Circuit Court of Appeals, Second Circuit, both on the ground that the Board was not warranted in considering or deciding the question of 1932 worthlessness as well as on the ground that there was no substantial evidence in the record to sustain the Board's finding of 1932 worthlessness. Neither in the deficiency notice, the petition filed with the Board, the trial before the Board, nor in the proceedings before the Circuit Court, was there any distinction drawn between the common and the preferred stock.

The Circuit Court held that the Board committed no error in rendering its decision predicated on 1932 worthlessness. On the question of substantial evidence, it held that the Board erred in finding that the preferred stock became worthless in 1932, but that it did not err in finding that the common stock became worthless in 1932 since reserves set up by accountants for the receiver as of December 31, 1932 wiped out all book equity for such common stock.

Statement of Facts Relating to Worthlessness of the Common Stock of the Middle West Utilities Company.

Middle West Utilities Company was a gigantic public utilities holding company. Its assets consisted almost wholly of investments in and advances to numerous subsidiary corporations of which some were subholding companies and others operating companies. On April 15, 1932 a federal district court in Illinois appointed equity receivers for Middle West on the ground of its inability to finance its obligations. At

that time the book value of the company's assets was over $308,000,000 with liabilities of approximately $73,000,000. Thus the books disclosed an equity for stockholder interests of more than $235,000,000. The stock outstanding was approximately 607,400 shares of preferred with a par value of $100 a share and 15,942,113 shares of common without par value but with a stated value of $10 a share.

Following the receivership of the parent company several of its subsidiaries went into receivership or bankruptcy in 1932 and the early months of 1933. By June, 1933, Middle West's investment in subsidiaries already in receivership was approximately $100,000,000. If the entire investment of Middle West in the subsidiaries placed in receivership in 1932 and 1933 were deducted from the book value of the Middle West assets the book value remaining would be over $200,000,000 as against $73,000,000 liabilities plus $60,740,000 preferred stock. None of the subsidiaries placed in receivership were reorganized or plans for reorganization filed prior to 1934.

Shortly after they were appointed, the receivers, pursuant to authority granted, retained Arthur Andersen & Company, accountants and auditors, to make an examination of Middle West and to prepare an annual audit of that company for the year 1932 (Ex. 17, p. 9). Under date of June 5, 1933, the receivers submitted their first report (Ex. 17) wherein they indicated that in accordance with the recommendations of the accountants (attached to and made a part of their report), they had caused reserves to be set up and charges made to surplus to provide against all possible losses on investments both in companies in receivership *as well as in those not in receivership.* After setting up all reserves for losses including those

not yet sustained or known but which might in future years be sustained, the book value remaining still totaled over $149,000,000 as against the liabilities of $73,000,000, and $60,740,000 preferred stock.

In the said report of June 5, 1933, the receivers indicated that they had not yet attempted to make an appraisal of the value of the Middle West assets, although they appreciated the justifiable desire of creditors and security holders to be informed as to the present and anticipated value of such assets. The receivers in their report stated further that——

> "very substantial values remain, chiefly in Middle West's control through common stock ownership of sizeable operating utility property well located throughout diversified territories" (Ex. 17, p. 1).

During Middle West's receivership several groups of interested parties also prepared reports of the financial condition and future prospects of the company. In the latter part of 1932 a committee for common stockholders sent out an optimistic report. Even more optimistic was a report by a committee for preferred stockholders under date of July 10, 1933.

The only pessimistic report was one issued in November, 1932 by a committee for the noteholders but that report stated that it "does not pretend to present the 'fair and reasonable' value of the assets".

In June 1934 the accountants submitted to the receivers a report as of December 31, 1933. This showed $205,000,000 had been written off of the Middle West Company's investments in subsidiaries both those in receivership as well as those not in receivership to provide for possible and contingent losses.

The receivership continued until July 24, 1934, when the receivers were superseded by a trustee appointed in reorganization proceedings under Section 77 B of the Bankruptcy Act.

In October 1934 a plan of reorganization was filed by Middle West Creditors. Thereafter and early in 1935 hearings were had before the bankruptcy court for the purpose of passing upon the fairness of the plan of reorganization and the solvency of the Middle West. At one of such hearings, Mr. Taylor, the attorney for the common Stockholders' Protective Committee, stated in open court that, on behalf of the common stockholders, he would no longer oppose Middle West reorganization although up to then such opposition had been made in the belief that additional funds could be procured either from private or public sources (Ex. 3B attached to deposition of Walter Shaw, pp. 5 and 6).

An appraisal made as of July 23, 1934, pursuant to court order, found that the liabilities exceeded the assets by more than $10,000,000. On November 27, 1935, the District Court confirmed a plan of reorganization. The court found specifically that as of July 23, 1934, Middle West was insolvent and that no equity existed for either preferred or common stockholders and that hence acceptance by the stockholders was not required for the confirmation of the plan. Nevertheless the plan provided for the issuance of new stock and warrants to the old stockholders on a certain nominal exchange basis. The record shows (fol. 290) that at the date of the hearing petitioners had not surrendered their old stock.

Specification of Errors to Be Urged.

1. The Court erred in holding that the Board was warranted in considering and deciding an issue not raised in the deficiency notice or litigated before the Board.

2. The Court erred in holding that petitioners were required to establish the existence of value of Middle West stock for years prior to 1934, when the Commissioner in his deficiency notice made a determination that that stock possessed value to the end of 1935.

3. The Court erred in not holding that the Board committed error in refusing to grant petitioners' motion for a reconsideration of the issue covering worthlessness prior to 1934.

4. The Court erred in not holding that the Board committed error in failing to reopen the proceeding for the introduction of evidence covering worthlessness prior to 1934.

5. The Court erred in not holding that in light of all the circumstances, petitioners did not receive a full and fair trial.

6. The Court erred in not holding that in view of the language of the deficiency determination holding that Middle West stock did not become worthless during or prior to 1934 and the basis on which trial of the proceedings was had, the finding of the Board that the stock was worthless in 1934 should have required judgment for petitioners.

7. The Court erred in holding that there was substantial evidence to support the Board's finding of

worthlessness of the common stock of the Middle West Utilities Co.

8. The Court erred in holding that the absence of book value for the common stock as shown in the statement of the accountants for the Receiver is sufficient to sustain the Board's finding of worthlessness of such common stock.

9. The Court erred in treating the reserves set up by such accountants to cover possible future losses in solvent companies as the equivalent of the destruction of present values.

10. The Court erred in not holding that even if Middle West's entire investment in companies in receivership were all eliminated the common stock would still have a book value as at the end of 1933.

Reasons for Granting the Writ.

1. Petitioners were denied a fair trial as both the Board of Tax Appeals and the Circuit Court of Appeals had based their decisions on a point not presented or argued by the litigants in the trial court, and which petitioners had never had an opportunity to meet by the production of evidence.

2. The holding of the court below that the Board may consider and decide a case upon an issue not raised or litigated before it and may do so even where the issue was waived or conceded by the Commissioner goes contrary to and is in conflict with the decisions of this court involving a somewhat similar question. *General Utilities & Holding Co.* v. *Helvering,* 296 U. S. 200; *Helvering* v. *Tex-Penn. Oil Co.,*

300 U. S. 481; *Helvering* v. *Wood*, 309 U. S. 344 at 349 and *Hormel* v. *Helvering*, 61 S. C. 719.

3. The question whether the Board of Tax Appeals may predicate its decision on an issue not raised or litigated, and on which taxpayers had had no opportunity to present evidence, on the theory that such taxpayers must always and under all circumstances prove all essential facts necessary to sustain a deduction, is one that to a great extent affects the public interest in view of the innumerable appeals taken to the Board, and the frequency with which this question would naturally arise.

August 23, 1941.

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